SAUDI ARABIA'S FISCAL DILEMMA: SUSTAINED GROWTH VERSUS INCREASED VULNERABILITY

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Abstract (Document Summary)

Fluctuating and declining oil revenues after 1982 have meant that Saudi Arabian planners have had to revise the country's long-run development strategy. By 1988 instead of high growth, industrial diversification, and rapidly improving standards of living, the government's main concerns have become focused on how best to utilize the country's dwindling oil revenues in order to assure positive overall rates of economic growth while meeting to the fullest extent possible the basic needs of the majority of the population. In fact, attempts to direct government spending towards the Saudi sector of the economy have been on the increase recently as the growth rate of government expenditure has been constrained.[1]

Attention has also been drawn to the role of the kingdom's financial institutions and what they have been doing to direct the nation's savings into productive projects. Figures for 1986 show that domestic lending by eight of the kingdom's eleven commercial banks fell by up to 25 percent over the previous twelve months. To be sure the general lack of business confidence has not been improved by the banks' continuing trouble with bad debts and interest (nearly always held illegal by Shari'a courts).

The ramifications of the three logical budget deficit programs were examined (Table 6) in the context of their impact on the private sector. The first fiscal strategy--"Slow Deficit Reduction Program"--constrained budget deficits between $15 and $13 billion in 1986, $13 and $11 billion in 1987, $12 and $10 billion in 1988, $10 and $8 billion in 1989, $8 and $6 billion in 1990, $6 and $4 billion in 1991, and a balanced budget in 1992. The second--"Rapid Deficit Reduction Program"--fiscal strategy constrained budget deficits between $25 and $20 billion in 1986, $15 and $12 billion in 1987, $10 and $8 billion in 1988, $5 and $2 billion in 1989, with balanced budgets in 1990, 1991, and 1992. Finally, the "Balanced Budget Program" assumes the actual deficit of $11.98 billion in 1986, and a balanced budget each year over the 1987-1992 period.

Full Text (5226 words)

Fluctuating and declining oil revenues after 1982 have meant that Saudi Arabian planners have had to revise the country's long-run development strategy. By 1988 instead of high growth, industrial diversification, and rapidly improving standards of living, the government's main concerns have become focused on how best to utilize the country's dwindling oil revenues in order to assure positive overall rates of economic growth while meeting to the fullest extent possible the basic needs of the majority of the population. In fact, attempts to direct government spending towards the Saudi sector of the economy have been on the increase recently as the growth rate of government expenditure has been constrained.[1]

The purpose of this paper is to examine the fiscal dilemmas that volatile and declining oil revenues are likely to pose over the remaining part of the 1980s, and up to 1992. In particular, an assessment is made of the magnitude of the tradeoff between increased government expenditure (and thus growth) and the size of the country's outstanding portfolio of foreign assets.

During the 1970s and into the early 1980s, crude oil output directly accounted for one half to three fourths of Saudi Arabian gross domestic product (GDP). Under the stimulus of massive oil revenues, the non-oil sector grew rapidly. The private non-oil economy expanded at an average annual rate of 13.0 percent per annum over the period 1973-83. The most rapidly growing sectors were construction, public utilities, and what are called "other" services, including trade, finance, and various other business and personal services.

Public spending was the principal factor in the kingdom's remarkable boom decade, which ended in 1983. To a great extent, growth continues to depend on the flow of funds through the government, but the volumes being disbursed at present (1988) are about 39 percent less (Table 1) than in 1983/84.[2]

This decline in government expenditures has produced a severe economic contraction, except in the area of agriculture. Gross domestic product (GDP) at constant prices was more than 24 percent lower in 1986 than in 1982 when national production was at its highest. Declines in growth have varied from sector to sector, being most concentrated in construction and finance:

Rate of Growth Rate of Growth

1982-86 1986

Agriculture 12.2% 13.0%

Mining -4.4 -3.3

Non-oil Manufacturing 4.0 -9.8

Construction -12.6 -20.0

Wholesale and Retail Trade -0.5 -11.7

Transport and Communication 1.4 -11.8

Ownership of Dwellings -3.5 -10.0

Finance -5.2 -15.7

Services 0.0 -3.9

Contraction was particularly sharp in 1986 when oil revenues fell by nearly 38 percent to SR88 billion--little more than a quarter of the peak attained four years earlier. The net effect was to cause the kingdom's gross domestic product to drop a further 12 percent after a 13 percent decline in the previous year. So uncertain was the revenue outlook that the government was in the embarrassing position of being unable to announce a budget.

Table 1. Saudi Arabia: Actual Revenue and Expenditure, 1983-1988 (Billion Riyals)

FISCAL PERIOD 1983/ 1984/ 1985/ 1986 1987 1988

84 85 86 (a) (b) (b)

Total Revenue 206.4 171.5 131.5 74.3 117.3 133.2

oil Revenue 145.1 119.0 87.7 41.9 79.3 68.9

Investment Income (b) 46.3 37.5 28.8 21.1 23.0 18.5

Other (b) 15.0 15.0 15.0 11.2 15.0 17.9

Borrowings - - - - - 27.9

Total Expenditures 232.2 216.4 181.5 136.7 170.0 141.2

Salaries (b) - - 50.0 50.0 55.0 60.0

O&M (b) - - - 17.5 20.0 20.0

Other Recurrent 124.2 120.4 70.5c 38.3c 42.9c 21.2c

Project 106.0 96.0 61.0 29.9 52.2 40.0

Surplus/deficit -23.8 -44.9 -50.0 -62.4 -52.7 -8.0

Cumulative deficit -23.8 -68. -118.7 -181.2 -233.8 -241.8

Source: Economist Intelligence Unit, Country Report: Saudi Arabia (No. 1, 1988), p. 11. Notes: (a) ten months only, (b) budget figures, (c) estimates

II

The fact that oil markets may not firm up until the early 1990s has finally been acknowledged by Saudi authorities, and the 1988 budget represents a major concession to that situation. The 1988 budget (Table 1) of SR141.2 billion (against the 1987 budget figure of SR170 billion), represents a nominal decrease in spending of 17 percent. It also represents only a 3.3 percent increase over the recently released SR136.7 billion actual figure for the 1986 budget period of ten months, and this a decrease on an annualized comparison basis. Because the Saudis have yet to publish actual figures for 1987, it is difficult to assess the extent of projected spending falls in 1988. There is, however, a strong suspicion that expenditures in 1987 were under budget, largely because revenue shortfalls are unlikely to have been made up by further deficit financing (already budgeted at SR52.7 billion).[3]

The key indicator of greater austerity in the new budget is the fact that the gross budget deficit (including bond financing) has been cut from SR52.7 billion in 1987 to SR35.9 billion in 1988. This figure represents the lowest deficit since 1984/85. Apparently the need to close the deficit is based not only on a lack of funds but also on the principle that while it was legitimate to continue using accumulated reserves for capital investment, it is less defensible to use capital resources for recurrent expenditures.[4]

Table 2. Saudi Arabia: Budgeted Expenditure by Sector, 1980-1988 (SR million)

Expenditure Category	1983	1984	1985	1986	1987	1988
Human Resource Development	31.8	27.8	30.5	24.0	23.7	21.7
Transport & Communications	38.5	25.0	23.6	16.5	11.9	10.2
Economic Resources	22.0	13.2	17.6	14.4	8.4	6.5
Health & Social	17.0	13.6	18.1	14.8	11.1	9.8
Infrastructure	11.5	9.6	9.8	6.7	4.3	3.1
Municipal Services	26.2	19.1	17.5	11.9	8.1	7.7
Defense and Security	89.9	75.7	79.9	64.1	60.8	50.8
Public Administration	84.4	47.1	35.1	30.0	31.3	25.0
Government Lending Inst.	19.5	20.0	17.5	9.3	3.6	0.8
Local Subsidies	11.2	9.0	10.5	8.3	6.8	6.0
Total	313.4	260.0	260.0	200.0	170.0	141.7

Sources: Saudi Arabian Monetary Agency Annual Report 1406 (1986), p. 208; Economist Intelligence Unit, Country Report: Saudi Arabia, (No. 1, 1988), p. 12.

Analysis of the distribution of expenditures by sector (Table 2) shows that the percentage cut in total spending is mirrored by the percentage cut in the defense and security budget. This is despite the impression given by government spokesmen that military expenditure will take an increasing share of the budget. Above average cuts in spending are found in the economic resources development sector, in public administration, and in new lending to credit institutions. The budget for human resource development is cut by less than 10 percent and that for infrastructure by less than 5 percent.

The small drop in the infrastructure budget reflects the steady or mounting cost of O&M contracts. Subsidies were budgeted to fall by only 11 percent, despite the anticipated cuts in certain areas. In general, the independent budgets are slightly down from 1987, although there are increases for the retirement pensions department, the Grain Silos and Mills Organization, the Saudi Seaports Authority, and the airline, Saudi. It is not clear to what extent the latter two increases are determined by larger self-funding operations, or whether the Saudi increase will be compromised by the suspension of planned airfare increases.

III

The business community has been apprehensive to the extent that longer-term domestic investments have fallen off fairly sharply in recent years. Construction activity--the hardest hit of all sectors, reflecting the fact that the kingdom's infrastructure is largely complete--dropped 20 percent, and contractors owed billions of dollars by the government suffered increasing delays in payment. Overstocked and overextended merchants competed to unload their inventories in a sluggish market. There was a rash of bankruptcies, bad debts, and commercial disputes. A number of foreign companies operating in the kingdom cut their losses and went home.[5]

These developments have prompted a debate in the kingdom as to how the economy can be encouraged to develop and expand. Some sections of the business community have been lobbying the government to increase its overall level of expenditure to help restore growth. In turn officials have been asking why the private sector, one of the wealthiest and most liquid in the developing world, is not doing more to help the process. Businessmen usually cite difficulties in identifying viable manufacturing projects, given the relatively small size of the Saudi and Gulf Co-operation Council markets and the relatively high costs of operating there. They complain that in the most potentially promising area of investment, petrochemicals and their downstream derivatives, the government through its majority ownership of Saudi Basic Industries Corporation (Sabic) is unresponsive to private-sector access to feedstock at advantageous prices.[6]

Attention has also been drawn to the role of the kingdom's financial institutions and what they have been doing to direct the nation's savings into productive projects. Figures for 1986 show that domestic lending by eight of the kingdom's eleven commercial banks fell by up to 25 percent over the previous twelve months. To be sure the general lack of business confidence has not been improved by the banks' continuing trouble with bad debts and interest (nearly always held illegal by Shari'a courts).

As noted above, the government has made strenuous and fairly carefully calibrated efforts to adjust to current much-reduced revenues. It has drastically reduced spending on new projects, reduced subsidies on things like food and gas, and cut salaries and benefits for its employees.

At the same time, for obvious political reasons, it has been anxious to limit the effect of the cutbacks on ordinary Saudis. To insulate the economy to a degree from the downturn in revenues it has drawn heavily on its overseas reserves. Estimates vary, but analysts estimate that as a result of running fiscal deficits since 1983 the kingdom's reserves have dropped to between $60 billion and $90 billion from their 1981 peak of more than $130 billion. In short, foreign exchange expenditure on imported goods and services has borne much more of the burden than spending at home.

The government is well aware that these policies on their own are not likely to be sufficient to keep the budget afloat through the present period of flat international oil prices, especially if, as many analysts predict, this lasts until the early 1990s.

In this regard, several budgetary problems stand out:

1. Recurrent expenditure--especially on such items as civil service salaries--has been rising as a proportion of the total public-sector budget, and it will be much more difficult to make further cuts without political repercussions.

2. The country's reserves are not infinite and would have fallen further but for fortuitous movements in the international capital and currency markets. For example, since the Reagan administration moved to freeze Libyan assets in the United States in 1983, Saudi Arabia has accelerated the diversification of its investments into currencies other than the dollar--especially the D-mark. it has thus benefitted from the sharp appreciation of the mark against the riyal, which is linked to the U.S. currency.

For their part Saudi officials have also attempted to increase revenue from sources other than oil and investment income (Table 3). As originally discussed in 1987 these measures would have included: income tax on expatriates; the raising of customs duties from 7 percent to 12 percent on most items and to 20 percent on industrial items designated for protection; the raising of surcharges on the cost of medical services, water, and electricity; the introduction of a stamp duty on real estate transactions; and the imposition of an airport tax. The list of surcharges is said[7] to have included a 5 percent stamp duty, a flat $2.60 fee on each domestic airline ticket, hospital visit, water and electricity bill, a $13 surcharge on international air tickets, and a fee of $52 for car and truck registration.

It is not clear how many of these new revenue measures have been abandoned or postponed, or how many of them were expected to aid the treasury directly rather than independent parastatals, such as Saudia or the General Electricity Corporation. It is clear, however, that even if all the extra charges are reinstated, they will only go a very small way towards boosting revenue. Oil revenues, investment income, and borrowing will provide the mainstay of the government's income.

Table 3. Saudi Arabia: Revenue Breakdowns (SR billion)

Actual Budget

1983/84 1984/85 1987 1988

Oil 164.5 164.4 79.3 68.9

Non-oil 60.5 49.7 38.0 36.5

Income Tax - - - 1.8

Zakat 0.4 0.6 - 0.9

Customs Duties 5.3 4.5 - 6.5

PTT 6.5 5.0 - 4.3

Public Service Charges 0.5 0.6 - 2.5

Revenue Stamps & Documents 0.2 0.3 - 1.3

Government Sales 0.1 0.6 - 0.7

Rents & Installments 0.6 0.7 - -

Miscellaneous 46.9 37.4 - 18.5

Total 225.5 214.1 117.3 105.4

Non-oil Revenue as a Percentage 36.8 30.2 48.0 52.9

of oil Revenue

Source: Economist Intelligence Unit, Country Report: Saudi Arabia (Number 1, 1988), p. 14.

Judging the real impact of the new charges on revenue is made more difficult by the fact that the Saudis have not released detailed revenue breakdowns for several years, and that in the middle of 1987 they revised their non-oil revenue projections downward from SR52.08 billion to SR38.02 billion without explanation. At a projected total of SR18 billion, revenue from taxes and other charges in 1988 would have been running about 25 percent higher than estimated in previous years (Table 3).

In terms of other major sources of revenue, it is clear that the kingdom has been facing a decline in its investment income, due both to falling levels of overseas assets and falling interest rates worldwide. It now appears certain that Saudi Arabia failed to make substantial capital gains on its investments in 1986, or presumably 1987, or alternatively that any such gains were passed straight through to spending ministries for extra budgetary expenses. The budget has put a ceiling on bond issues of SR30 billion for 1988, although in the actual budget breakdown borrowing of SR27.9 billion was assumed to be required as long as other revenue targets were met.

In summing up the 1988 budget, it is clear that the government's fiscal strategy was notice of a fairly radical shift in Saudi Arabia's economic policy. In essence, the strategy of allowing all possible input costs to fall or stagnate in the interests of creating a competitive non-oil sector was abandoned so as to correct the balance of payments deficit and stem the drawdown on reserves. This switch seemed to be predicated on a precarious position with regard to financial reserves, and an acknowledgement that the oil market was going to remain weak for some time to come.

A squeeze on consumption by raising customs duties and reducing either the number of expatriates or their spending power would have been expected to have an immediate effect on imports. But while local manufacturers might have hoped to benefit--and the need for protection in certain cases was already accepted by the government--importers would clearly have suffered. Moreover, the private sector has consistently argued that Saudiization, with its attendant costs, cannot reasonably be imposed during a period of economic austerity.

The new direction in Saudi policy was generally welcomed overseas. It seemed to hold out the promise of more flexibility in Saudi oil policy as pressure for maximization of oil revenues for budgetary purposes eased. Yet there appears for the moment to have been a complete return to the previous emphasis. Certainly some of the new measures were ill-conceived, such as the imposition of income tax schedules at 1973 levels or the adoption of a customs tariff that contradicted GCC policy and might have encouraged smuggling into rather than out of the kingdom. The principal dilemma now is whether small gains in revenue can compensate for public disaffection, the probable reversal of economic recovery, and the loss of private-sector confidence.

In the short term, until the government finds an acceptable way of bringing in taxes or fees, the kingdom will be all the more dependent on funds raised by the planned bond issues. As of May 1988 the detailed nature of these debt instruments had not been published. But they are expected to be issued in the first instance to specialist institutions like the General Organization for Social Insurance (GOSI) rather than to individuals or even to banks. Borrowing of this kind is, after all, controversial in light of the religious objection to interest payments.

If the kingdom does eventually decide to tap the banks, it is not expected to have any problems raising the funds it needs.

Private-sector liquidity remains abundant and bond issues might persuade the banks to repatriate some of their substantial foreign assets.

In any case, it is likely that the government will face falling or at best stable oil revenues for the next several years, and we will now move on to examine the budgetary dilemmas that volatile and declining oil revenues are likely to pose over the remaining part of the 1980s, and up to 1992, particularly tradeoffs between economic growth and foreign portfolio holdings that are likely to confront the government under alternative budgetary scenarios. We will also examine the impact on private-sector activity of alternative fiscal programs dictated to a large extent by development in the oil markets and the government's willingness and ability to finance added expenditures out of its foreign portfolio.

IV

Within the context of the budgetary developments outlined above, assessments of Saudi Arabia's fiscal alternatives were made using an optimal control model of the economy.[8]

In order to determine the sensitivity of the results obtained from the alternative fiscal programs in the optimal control simulations, four forecasts of export earnings were made (in order of likelihood):

1. "Fluctuating Oil Markets": -16.0%, 1986; -8.0%, 1987; -4.0%, 1988; 0.0%, 1989; +2.0%, 1990; +4.0%, 1991; and +6.0%, 1992.

2. "Recovering Oil Markets": -16.0, 1986; +1.0%, 1987; +2.0, 1988; +3.0, 1989; +4.0, 1990; +5.0, 1991; and +6.0, 1992.

3. "Stable Oil Markets": -16.0%, 1986; 0.0% for the 1987-1992 period.

4. "Declining Oil Markets": -16.0%, 1986; -2.0% per annum over the 1987-92 period.

These four oil scenarios are intended to map out a general matrix of environments in which government fiscal policy can be conducted.

The main findings (Table 4) of this exploratory analysis indicated that:

1. Inflation presents no particular difficulties in the range of expenditures likely to be undertaken by the government.

2. Given present levels of foreign-asset holdings, fiscal deficits averaging around $10 billion per year are probably the maximum the government would be able to sustain over the 1987-92 period without recourse to external borrowing.

3. Private sector demand (consumption and investment) appears relatively resilient, i.e., it does not decline nearly as rapidly as government expenditures during periods of declining oil revenues and/or fiscal austerity.

4. The most significant finding of this exploratory analysis was that private sector output as a whole is likely to continue declining and would regain a positive rate of expansion only under the most favorable set of assumptions concerning oil markets and sustainable levels of government expenditures. In part, however, this result is conditioned by the fact that much of the kingdom's major construction works are now completed--the construction sector would contract irrespective of developments in world oil markets.

Table 4. Saudi Arabia: Portfolio--Growth Tradeoffs, 1986-1992, Alternative Oil Scenarios (average annual rates of growth)

Expenditure Conditions in oil Markets

Category

Recovering Stable Deteriorating

Government Expenditures -1.9 -3.3 -4.3

Consumption -2.6 -3.8 -4.5

Investment -0.2 -2.0 -3.1

Private Expenditures 0.2 -0.7 -1.3

Consumption 0.7 -0.2 -0.9

Investment -1.9 -2.7 -3.2

Private Sector Output -1.1 -2.0 -2.6

Non-oil GDP 1.0 0.1 -0.3

Cumulative Budget Deficit

(billions 1970 rivals) 69.77 70.00 69.1

Notes:

The fiscal deficit is held in the range of $10 billion per annum.

Recovering oil market scenario assumes the following rates of growth in oil revenues:-16.0% (1986), 1.0% (1987), 2.0% (1988), 3.0% (1989), 4.0% (1990), 5.0% (1991), and 6.0% (1992).

Stable oil market scenario assumes the following rates of growth in oil revenues:-16.0% (1986), 0.0% for the 1987-92 period.

Deteriorating oil market scenario assumes the following rates of growth in oil revenues:-16.0% (1986), -2.0% per annum over the 1987-92 period.

5. In all scenarios private sector demand will have to increase vis-a-vis that of the government to levels not experienced since the pre-1973/74 oil price increases. The ratios of private to government expenditures are not higher and in many cases are lower than those experienced in the early to middle 1960s.[9]

6. Reducing military expenditure (given a specified budgetary target) does not stimulate private sector output growth.

Based on the finding summarized above, simulations were structured to examine the consequences of alternative fiscal programs in the "Fluctuating Oil market" environment outlined above. These fiscal programs involved:

1. Annual budget deficits in the $10 billion range.

2. Annual budget deficits in the $15 billion range.

3. Annual budget deficits in the $20/25 billion range.

Given these possible fiscal programs it appears (Table 5) that:

1. Deficits in the range of $10 billion are needed simply to prevent decline in non-oil GDP. At the same time, however, real private sector output would decline at an average annual rate of 2.5 percent. Because the construction sector contracts at an average rate of 4.0 percent, most of the other sectors show modest reductions (agriculture actually increases at an average annual rate of 2.9 percent per annum).

2. Increasing the budget deficits to the $15 billion per annum range would involve running an accumulated deficit of approximately $96 billion. This added deficit would increase the rate of growth of non-oil GDP from zero to 0.5 percent per annum. Private sector output would still decline, but at an average annual rate of only 1.8 percent per annum. In other words, risking dangerously low levels of foreign assets and/or the necessity of foreign borrowing would seem to pay relatively low returns in terms of obtaining major improvements in the rate of expansion in private sector activity.

3. Budget deficits in the range of $25 billion per annum would probably be required (given the situation in construction) to prevent declines in real private sector output.

Table 5. Saudi Arabia: Portfolio--Growth Tradeoffs, 1986-1992, Fluctuating Oil Markets: High Fiscal Deficits (average annual rates of growth)

Expenditure Budget Strategy--Annual Deficits ($billion)

Category

10 15 20/25

range range range

Government Expenditures -3.9 -2.9 -0.8

Consumption -4.4 -3.4 0.9

Investment -2.5 -1.4 0.9

Private Expenditures -1.2 -0.6 0.5

Consumption -0.7 -0.2 0.8

Investment -3.2 -2.4 -0.5

Private Sector Output -2.5 -1.8 -0.3

Non-Oil GDP 0.0 0.5 1.3

Cumulative Budget Deficit

(billions 1970 rivals) 71.9 96.24 162.5

Note: Fluctuating oil revenues scenario assumes the following rates of growth in oil revenues:-16.0% (1986), -8.0% (1987), -4.0% (1988), 0.0% (1989), 2.0% (1990), 4.0% (1991), and 6.0% (1992).

Rather than risk dangerously low levels of foreign asset holdings, the Saudi government might opt for a strategy of balancing the public sector budget immediately, or at least by the early by the early 1990s. In addition to maintaining the security and revenue generating capacity associated with its foreign portfolio, several major political advantages could be derived from this strategy: first it would assure the local business community that the government was able to manage the economy in a period of crisis. Second, the religious community would probably welcome this move as a sign that the government was not committed to modernization at all cost. Finally, public laws prohibiting government borrowing would not have to be overturned (thus opening up fears of a renewal of the fiscal abuses of the 1950s).

The ramifications of the three logical budget deficit programs were examined (Table 6) in the context of their impact on the private sector. The first fiscal strategy--"Slow Deficit Reduction Program"--constrained budget deficits between $15 and $13 billion in 1986, $13 and $11 billion in 1987, $12 and $10 billion in 1988, $10 and $8 billion in 1989, $8 and $6 billion in 1990, $6 and $4 billion in 1991, and a balanced budget in 1992. The second--"Rapid Deficit Reduction Program"--fiscal strategy constrained budget deficits between $25 and $20 billion in 1986, $15 and $12 billion in 1987, $10 and $8 billion in 1988, $5 and $2 billion in 1989, with balanced budgets in 1990, 1991, and 1992. Finally, the "Balanced Budget Program" assumes the actual deficit of $11.98 billion in 1986, and a balanced budget each year over the 1987-1992 period.

In general:

1. The accumulated (1986-92) deficits of the slow deficit reduction and rapid deficit reduction program are $56 and $45 billion respectively.

2. Interestingly enough, both programs are associated with the same contraction in non-oil GDP of 1.2 percent per annum. Private sector output contracts at an annual rate of 3.4 percent per annum with the slow deficit reduction program, and 4.1 percent per annum with the more rapid deficit reduction program.

3. It is apparent, therefore, that reducing the accumulated deficit from annual deficits in the $10 billion range to a targeted balance does have fairly high deflationary cost, in terms of reducing the incentives for private sector output--reducing the accumulated deficit from $71.9 billion (Table 5) to $45 billion (Table 6) accelerates the contraction of private sector output from 2.5 percent per annum to 4.1 percent per annum. Correspondingly, the decline in non-oil GDP increases from a stationary level to a decline of 1.2 percent per annum.

In sum, the results of these simulations indicate that the gains obtained from deficits in the $20-25 billion range are fairly marginal: the chief accomplishment of the high deficit program is to sustain a positive overall rate of expansion of non-oil GDP (1.3 percent per annum). Private sector standards of living (as proxied by the level of private consumption) are also stabilized. Private sector investment suffers only a slight decline and is poised to expand in the 1990s, assuming improved oil markets. Weighed against the costs (nearly $90 billion in deficits compared with the annual deficits of $10 billion) these benefits do not appear to be worth the increased levels of risk associated with a depleted foreign asset portfolio.

Table 6. Saudi Arabia: Portfolio--Growth Tradeoffs, 1986-1992 Fluctuating Oil Markets: Balanced Budget Target (average annual rates of growth)

Expenditure Budget Deficit Reduction Strategy ($billion)

Category

Slow Rapid Balanced

Reduction Reduction Budget

Government Expenditures -5.8 -6.6 -6.9

Consumption -5.8 -6.9 -7.5

Investment -5.1 -5.4 -5.6

Private Expenditures -1.9 -2.5 -3.3

Consumption -1.4 -1.8 -2.4

Investment -4.0 -4.9 -5.6

Private Sector Output -3.4 -4.1 -4.5

Non-Oil GDP -1.2 -1.2 -1.0

Cumulative Budget Deficit

(billions 1970 riyals) 56.46 45.07 0.0

Notes:

Fluctuating oil revenue scenario assumes the following rates of growth in oil revenues:-16.0% (1986), -8.0% (1987), -4.0% (1988), 0.0% (1989), 2.0% (1990), 4.0% (1991), and 6.0% (1992).

Slow deficit reduction program gradually reduces budgetary deficits to zero by 1992.

Rapid deficit reduction program reduces budgetary deficits to zero by 1990.

Balanced budget program assumes a deficit of $11.98 in 1986, and a balanced budget each year 1987-92.

Similarly, the costs of maintaining a balanced budget appear fairly high--with private consumption declining at an average annual rate of 2.1 percent and private investment at an average annual rate of 5.8 percent. Private sector output, which showed only a slight reduction under the high deficit program, now contracts at an average annual rate of 4.5 percent per annum.

V

The thrust of the analysis above has been to examine the fiscal dilemmas confronting Saudi Arabian policymakers during an era of unstable and likely declining oil revenues. In large part, the simulations presented above indicate that under a wide range of oil market conditions the government will be faced with protracted cutbacks in expenditures. This result stems from the fact that non-oil revenues are unlikely to be buoyant. As a result it is clear that without major changes in national priorities (in terms, for example, of the willingness of the government to initiate external borrowing) it is unlikely that the private sector will be able to sustain positive overall rates of economic growth over the 1986-1992 period.

However, if the government is willing to run continued budget deficits in the range of those of the last several years (around $10 billion per annum) over this period, and accept modest reductions in growth and development, it may be possible to preserve a sizeable portion of its portfolio for future contingencies.

One logical way of dealing with this problem is to explore new ways of borrowing. The government has not issued debt for over twenty years, but the 1988 budget is encouraging in that it acknowledges the need to raise additional funds in the domestic capital markets. More precisely the authorities hope to raise about $8 billion to cover their projected $10 billion deficit. This has proved to be fairly tricky, because the authorities have to avoid the problem of interest, the paying or acceptance of which is of course forbidden under Islamic Sharia law. This has led the Saudi Arabian Monetary Authority to experiment with new debt instruments, one of which it calls a development bond. These pay investors through anticipated cash flows from presumably future (unspecified) projects, i.e., the return on the bonds is able to be treated not as interest but as shared profit.[10]

While it is still unclear whether this type of instrument will go all the way towards satisfying the kingdom's powerful religious conservatives (and bankers who are confused about what exactly the bonds are supposed to be and what yields might be expected), the development of novel debt instruments of this type is clearly a sign that the country is finally beginning to deal realistically with its medium-term economic problems.

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NOTES

[1.] The Arab Economies: Structure and Outlook, 2d rev. ed. (Bahrain: Arab Banking Corporation, 1986), p. 132.

[2.] Data are from Saudi Arabian Monetary Agency, Research and Statistics Department, Annual Report 1406 (1986), p. 30 (1987).

[3.] Economist Intelligence Unit, Country Report: Saudi Arabia (no. 1, 1988), p. 11.

[4.] Ibid.

[5.] Andrew Gowers, "Caught Between a Rock and a Hard Place," Financial Times (13 April 1988), p. IV.

[6.] Ibid.

[7.] Economist Intelligence Unit, Country Report: Saudi Arabia, p. 13.

[8.] The econometric, optimal control model of the economy developed at the Naval Postgraduate School for the purpose of undertaking these simulations is detailed in Robert E. Looney, "Saudi Arabia's Fiscal Strategies in an Era of Fluctuating Oil Revenues," paper presented at the Western Economic Association Conference, Los Angeles, June 30-July 3, 1988, copies of which are available from the author. The advantage of models of this type is is that in contrast to other forecasting models they are able to steer the economy to a specific target. In contrast to macroeconomic forecasting, we can assess the feasibility of that target. If feasible, the model is capable of evaluating alternative paths over time, and on the basis of national priorities, choosing that path that provides the greatest net benefits and/or lowest costs over alternative paths. In short this approach is ideal for examining alternative budgetary tradeoffs of the type the Saudi authorities are currently confronted with.

[9.] As a basis of comparison, the ratio of private to government expenditures averaged 3.0 over the period, 1960-64; 1.4 for the 1965-69 period; 1.3 for the 1970-74 period; 0.8 for the 1975-79 period; and 1.1 for the 1980-85 period. In most of the simulations undertaken here this ratio increased to the 1.35 range.

[10.] Finn Barre, "Saudis Improve on Funding Theme," Financial Times (28 June 1988), p. 28.